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Remarks of
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"Restructuring The Wholesale Power Market: Today's Report Card"

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"Retail Competition:
Right Train, Wrong Track?"

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I.

I last spoke to NASUCA in March of 1997, before becoming Chairman. I therefore had less newsworthy things to say on the subject of the restructuring of the electric industry. Yesterday I went back to look at some observations I shared at that time about Order Nos. 888 and 889 -- then just a year old. Mainly, I talked about how transmission open access would accelerate change in the industry by requiring comparable service for all users at the grid; how the orders would add transactional liquidity to the

wholesale market; and how we proposed to ensure that transmission services would be separately priced, posted, and negotiated on electronic media. It was a rosy picture. As I recall, I wisely left the fate of retail competition programs –- including low-income subsidies, other potentially stranded benefits, demand side management, retail reliability supplier of last-resort concerns, and the future of service in lower-cost jurisdictions –- for the Congress and the states to work out among themselves. Since then, 25 states have moved bravely ahead on retail competition. The once-widespread fear that either the Congress or the Commission would dictate the evolution of retail markets has proven baseless. We clearly work in different policy and business environments than we did four years ago.

In the interim, however, my confidence that the Commission's 1996 orders would ensure the emergence of transparent bulk power markets has been tempered by

subsequent developments. Warnings about the prospect of declining reliability, Congress' inaction on restructuring, the Eighth Circuit's <u>Northern States Power</u> decision, and the persistence of some state commissions in believing that large amounts of interstate transmission must be forever dedicated to specific retail loads, and even some indications that utility investments and capabilities in the e-commerce area are lagging, have all clouded what I thought was a pretty clear and simple forecast for an open and competitive transmission network environment.

Despite these developments, the Commission has moved ahead on creating regional transmission organizations (RTOs). Right off the bat, RTOs will spawn two historic developments in this industry -- vertical disaggregation of utility functions in support of regional grid management arrangements and a housecleaning of current obstructions to efficiency in

the interstate market; that is to say the elimination of pricing and congestion barriers across multiple transmission systems, thereby enabling new supply sources to enter markets in greater numbers to compete for load. As I have said before, Order No. 2000 and RTOs provide a framework for solving a variety of problems that stand between the utility industry of the past and the power business of the 21st century. I give it an "A" but we need to put its precepts to work.

II.

The past three years have been an extraordinary time for the Commission and for the power market. We are both in a fundamentally different place. I am reminded of the eloquence of Gerald Ford, something to the effect that "Things are more like they are today than they have ever been before." It does seem that many of the tasks we face today confronted us back in 1997, when we last talked. To them, we can add some remarkable new challenges. As always, there are those

who believe nothing's broke, those who still stand to realize benefits from delay, and those for whom the advantages of incumbency are cherished and worth preserving. This is not to minimize the tax, operational, and even cultural challenges of making basic changes work for these companies. These are business as well as public policy problems and different companies have differing strategic imperatives. It is not unexpected that some would want to shoot the messenger of change by accusing FERC of using RTOs merely to expand jurisdiction and launch a new round of market intervention. But, as Prime Minister John Major once said about the British, "when we have our backs to the wall, we turn and fight!"

Indeed, given that electric restructuring is proving to be neither easy, nor finite in duration, nor a cause celebré for the American consumer (yet), what are we fighting for? I would never concede that we are fighting this battle only for large consumers of power.

True, they are among the most immediate beneficiaries of the opportunity to shop for electricity. Yet, we have seen competition in the natural gas and telecommunications arenas substantially reduce bills to even the smallest customers. This will prove to be the case for electricity in many places, even though the cost of power for most households rank behind those for housing, apparel, health care, and transportation. A savings of maybe 5 percent off monthly residential bills might amount to just $5 in many jurisdictions. Is it worth the effort to choose?

I would not underestimate the power of the prospect of choice for consumers, especially in a convergent, e-commerce environment. The American Gas Association, the Brookings Institute, and others predict significant consumer savings. Perhaps states are better positioned to resolve this debate about potential savings to average ratepayers, as well as questions about service reliability, social benefits and environmental issues.

Clearly, it would be unconscionable if small customer benefits, universal service requirements, and retail reliability became casualties of competition.

For its part, however, the FERC is pushing wholesale competition, without particular regard for the face of retail markets. Grid-related issues and market economics require it to act. Efficiencies and cost savings in the way power is produced and sold have not been fully realized at the bulk power level. It is critical that the wholesale market be as fair, transparent, and as efficient as possible, whether residential or commercial power consumers participate in that market directly, as they can in "open" states, or whether they participate in it through their traditional monopoly suppliers in states which (unwisely I think) believe that more diverse service and supply options are not essential to maintain historically low prices and high reliability in the future.

In any event, the Commission's agenda in promoting RTOs is limited and discrete. We have been advocating bulk power competition, even as we continue in our traditional cost-of-service regulatory role. It is where we see things going. I have repeatedly asked the Congress to help us get there. It is important that our Federal Power Act authority to order RTOs be reinforced. It would help us crystalize a vision of the competitive bulk power market. I have also requested Commission jurisdiction over all transmission, including that owned by cooperatives, municipal utilities, and federal utilities. I ask, not because the Commission wants to prescribe how they carry out most of their historical functions, but because the whole grid must operate under the same rules, like a machine, to be efficient. I have also supported legislation that would develop a new platform for the bulk power reliability system, based in part on the Commission's enforcement powers.

Transmission, while clearly not the biggest investment for vertically integrated utilities, is a strategic asset. It can be a source of tremendous market power. Congestion makes money for someone. I am therefore not surprised that changes in who can use those facilities, and under which conditions, raise questions and may be resisted. On this key point, NASUCA and the FERC agree and I wish to thank you for your comments on our original proposal. You stated that "the traditional means of grid management is showing signs of strain and . . . continued discrimination in the provision of transmission services by vertically integrated utilities may be impeding the development of fully competitive electricity markets." Well said. We bonded on that issue.

I strongly believe that real RTOs, as Order No. 2000 defines them, will deliver the goods for consumers and the economy. I also believe that the growing

number of retail access programs will fail if wholesale markets are not open and fluid. Bulk power must go where physics dictate and the market decides, based on clear commercial rules and market transparency and not on jurisdictional demarcations or any residual opportunities to game the system unfairly. Not insignificantly, RTOs will contribute to reliability. It is useful to note that competition across the interstate natural gas transportation system substantially enhanced both service options and service reliability. The same holds true here. The Commission projects over $2.4 billion in average annual savings from RTOs and other estimates range higher. RTOs will also help the Commission make good on the cost savings we promised in Order No. 888 but which will not be fully realized unless and until all transmission service is subject to open access and unbundling of major amounts of transmission, now irretrievably dedicated to specific native loads, is brought within the reach of a system where all uses of the grid receive comparable treatment.

In this connection, I recognize that those states which still wish to retain authority over the rates, terms and conditions of bundled retail transmission service seem to view wholesale competition as a net loss of benefits to their in-state consumers. I know of no support for this. There is no dispute that a state can grant or deny retail access. The FERC does not want to regulate the retail marketplace. It does not for a moment discount the difficulty of the issues that competition raises at that level. But the Commission should not be denied the ability, which is critical to the fairness and transactional liquidity of interstate transmission network operations, to ensure that the system delivers competitive benefits to the whole economy, even if individual states decide –- as they may under current law –- that retail competition is not in the interest of their citizens.

If RTOs are so critical to wholesale competition and reliability, you might ask why the Commission in Order No. 2000 took the route of voluntarism, collaboration, and benchmarking their development. One frustrated customer group in the Midwest recently exclaimed that "[o]ur present status of uncertainty and jeopardy is due in part to FERC's reliance on incumbent transmission owners to voluntarily adopt and implement reforms . . . " Transitions are tough and this is no exception. That is not a reason to push away from the negotiating table, however. RTOs are new and we learn more every day. In the next six months, we must squarely confront the resistance to change, find workable solutions, and develop strategies for implementation. I would stake my reputation that the good faith of market participants and strategic self-interest will yield real results. Because this is a matter involving a critical public interest, I do not wish to be disappointed.

III.

Let me close by returning to reliability, the "third rail" of electric restructuring. Several things are clear. The competitive market is in its infancy. We are in the process of developing new market models and market mechanisms are therefore immature and uncoordinated in many ways. Yet, wholesale transactions are burgeoning in numbers and complexity. Sales of bulk power grew 400% in the past four years, says EPRI. Competition and cost controls are eroding the willingness of parties to pay common costs. For example, demand-side programs, new (strategically located) generation, and transmission construction are not keeping pace with electricity demand, which is increasing for the first time in a generation. Congestion is appearing where it has never been a problem. These are challenges that can be met. And while we are doing that, we must do whatever is required to maintain the quality of service.

That too is problematic. Capacity shortfalls are another sign of trouble. Some say the Midwest will be more than 700 MW short next summer. And we all remember the extraordinary price spikes of two summers ago when events conspired to exacerbate supply shortages and the market was not sufficiently transparent in the country's mid-section to compensate for them. The Northwest Power Planning Council believes that, without 3,000 MW of new generation by 2003, there is a one-in-four chance of winter blackouts. EPRI says local outages doubled in the U.S. between 1996 and 1998 because of strong demand. Last summer witnessed historically high peak demands and levels of electricity imports, which took the Northeast to the brink. The new ISOs there helped manage the problem effectively. An EPRI official was recently quoted by the Wall Street Journal as believing there is a serious "mismatch between the capacity of the grid and demand" in the U.S. It appears to me that no combination of grid expansion, additional generation, and load shedding will be sufficient to avoid a high level of stress this summer and perhaps next. There may be no magic wand, but we can do something.

I still advocate the self-regulation of reliability mechanisms by industry participants, in the same way that securities markets operate under SEC supervision. But in the final analysis, a completely voluntary system for setting and enforcing reliability standards will no longer work in this dynamic market. Congress has before it a set of solutions for this problem. I am not prepared, however, to say that stand-alone reliability legislation will do the trick entirely. This is because any assurance of future reliability must inevitably be tied to the workability of competitive markets -- that is to say, to RTOs and the regionally uniform commercial and operational practices they can support. That is where we at the FERC are focused.

If the electric system is perceived to be at risk by most Americans, the evolution of the market will be delayed. The competitive model even could be abandoned. That may suit many powerful interests, which have yet to figure out how to redeploy their assets profitably. My immediate concern is that electric reliability might easily replace gasoline prices on the front page of the Nation's newspapers. We can count ourselves fortunate that it has not, at least in one sense, and unfortunate in another. I applaud your work for America's energy consumers. Yet, I remind you that their interests are just as much at stake in wholesale restructuring as they are in the retail markets in which you work most closely. We are all -– in one sense or another –- consumer advocates.

The FERC and NASUCA therefore need to work together to ensure that these new energy markets are competitive, fair, efficient, transparent and, most important, reliable. Modern electricity and natural gas markets have no precedents in the history of our energy economy. Just as with prices at the pump, keeping the lights on is the primary basis upon which most Americans will judge whether we have succeeded in securing the energy future. Even more than price, it is the acid test. I cannot tell you not to worry about whether we will pass that test. However, I can tell you two things with reasonable confidence. First, restructuring is headed in the right direction, although unfortunately there are ample remaining opportunities left for sub-optimal solutions and poor policy choices. Second, I believe that federal and state policymakers, in cooperation with all segments of the electric industry, must recognize that the only option is to push ahead deliberately –- not recklessly -- in completing the reinvention of the electricity marketplace. I welcome your participation in that fight.

Thank you.